First Financial Group

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1869 Charter Lane, Ste. 201, Lancaster, PA 17601 (717) 393-4465 FAX (717) 393-6115 www.firstfinancialgroup.com

Hedging

Against Mandatory Career Change

Every now and then, somebody gets lucky, but statistically, the “lottery-ticket” method for achieving financial prosperity rarely works. The surest path to wealth accumulation requires diligence – we have to keep doing what’s good for us, incrementally compounding over a lifetime. This is no small task, because the chances for long-term success are often challenged by short-term uncertainties. **How can we keep unforeseen circumstances from derailing our efforts to stay on track?** This is the essence of risk management in personal finance.

We may recognize risk management as an essential component of our financial plans, but often address the topic like financial broccoli; we try to get our required minimum servings, then move on to foods with greater appeal. This is understandable. However, current economic trends should compel individuals and households to pay careful attention to their risk management components, **particularly the ones designed to protect their income.**

Income – the critical resource

For most Americans, the ongoing ability to earn an income is their critical wealth-building component. Personal income is the source for saving, acquiring property, paying for insurance, and providing for retirement. **It must be protected, because if there’s no income, there’s no wealth accumulation.**

Everyone – governments, financial institutions, employers, unions, individuals – understands the essential role of steady income in personal finance. States and the federal government oversee unemployment benefit programs. Providing disability benefits for all Americans is a significant function of Social Security. It’s the reason employers offer group life insurance and disability plans to their employees, and individuals purchase personal policies. While surveys suggest the average American is under-capitalized and under-insured, most people understand the income protection value of these programs and policies.

A disability or a premature death represents a major threat to maintaining a steady income and building wealth. But in turbulent economic times, even healthy, educated, and motivated workers cannot presume steady employment and regular paychecks. In a section titled “Idled America,” a February 6, 2014, *Wall Street Journal* article noted the following:

More than one in six men ages 25 to 54, prime working years, don’t have jobs – a total of 10.4 million. Some are looking for jobs; many aren’t. Some had jobs that went overseas or were lost to technology. Some refuse to uproot for work because they are tied down by family needs or tethered to homes worth less than the mortgage. Some rely on government benefits. Others depend on working spouses.

The trend has been building for decades, according to government data. In the early 1970s, just 6% of American men ages 25 to 54 were without jobs. By late 2007, it was 13%. In 2009, during the worst of the recession, nearly 20% didn’t have jobs. Although the economy is improving and the unemployment rate is falling, 17% of working-age men weren’t working in December [2013]. More than two-thirds said they weren’t looking for work, so the government doesn’t label them as unemployed.

Some speculate the numbers for women are similar, but because they frequently leave the workforce to have children, there is less statistical clarity. Still, it is apparent: a single period of

In This Issue…

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extended unemployment can have the same financial impact as a premature death or disability. It can mean the end of accumulation aspirations – for the rest of one's life.

The longer one is without a job, the harder it becomes to get one; and rapid technology change makes non-workers less employable every day. The same challenge applies to disability. The Social Security Administration finds that "very few who get benefits return to work…(E)ven those who apply for disability and are rejected are unlikely to work again." Many Americans are ill-prepared to handle life without a paycheck, especially if it's the result of a layoff precipitated by a down-sizing or shrinking job market.

Paycheck alternatives

Yet there are time-tested ways to address income disruption. The most obvious is to pursue a new career path, often through new training or education. But an employer's paycheck is not the only strategy for systematically building financial security. You can "create" a paycheck with self-employment, start or buy a business, or develop passive income from real assets (such as apartment rentals). In fact, experienced workers might find these entrepreneurial options both profitable and fulfilling.

What do these career change alternatives require? Readily available cash reserves. These cash funds can: pay living expenses during a transition, provide seed capital for a start-up, or buy assets. But career changes like this usually aren't cheap; any one of these hypothetical options could quickly reach six figures in a very short time. How many American households could meet the cost of a $100,000-200,000 career change? Not many.

A mid-2013 survey from Bankrate.com reported that "fewer than one in four Americans have enough money in their savings account to cover at least six months of expenses, enough to help cushion the blow of a job loss, medical emergency or some other unexpected event." Even worse, the same survey concluded that three-quarters of Americans are living paycheck-to-paycheck, with little to no emergency savings. The straight-up truth is most Americans don't have a risk management program that will truly protect their wealth objectives if their paychecks disappear. Unemployment and insurance benefits might allow them to survive poverty, but any plans beyond subsistence are off the table because they didn't have the cash to effect a successful transition.

Cutting corners and getting whacked

Slow and steady wealth-building strategies are predicated on steady employment. From a planning perspective, there is a tendency to assume a regular paycheck equals permanent income. A regular paycheck is the justification for committing to a mortgage or making deposits in tax-deferred retirement accounts. Occasionally, there might be some lip service to the value of an "emergency fund," but it's often a one-sentence drive-by before moving on to the details of a 15- or 30-year amortization, or the optimum contribution mix in a 401(k).

Because of a regular income, employees may also see their retirement plan as an emergency fund, because they can typically borrow against the accumulation. If the house needs a new roof, or a health situation incurs extra medical costs, the money can be borrowed and repaid. A 2013 study found that 28% of workers with tax qualified retirement plans had tapped them to pay current expenses.

> Most Americans don't have a risk management program that will truly protect their wealth objectives if their paychecks disappear.

Another pseudo-emergency cash reserve for those with steady employment is a home equity line of credit. Tapping a line of credit typically doesn't incur a tax, and minimum monthly payments may be as low as the interest charged (which may be tax-deductible).

But remember, the statistics cited earlier show the ***true unemployment rate is almost three times higher today than it was 25 years ago.*** An income disruption is more likely today than ever. How well do retirement accounts and home equity loans work as income risk management tools if the paychecks stop?

Terminated employees can access their retirement account balances, but only as withdrawals. These distributions are taxable as regular income, and if taken before age 59 ½, incur an additional 10% penalty. In addition, any outstanding loans must be repaid in full at termination or they are re-characterized as withdrawals. Incurring maximum taxation while unemployed makes retirement accounts costly and inefficient to be considered emergency reserves in the event of an income disruption.

Similarly, home equity loans work better when you are employed. Adding another monthly obligation when income stops is not ideal. Housing markets fluctuate; a combination of increased debt and declining values could leave a homeowner upside-down, making it harder to sell the property if, for example, a new job requires relocation.

Cash Reserves: basic characteristics

Cash reserves don't have to be "mattress money," stacks of bills in a bedroom safe, or shoeboxes in a basement ceiling. A variety of financial instruments could serve as cash reserves, if they possess some or all of the following characteristics:

Readily accessible. Not the 24-hour access of an ATM, but money that can be received within a week, and doesn't require a loan review or a bank officer's approval. You ask for the funds, you get a check.

Guarantees on principal. If you set money aside, you want to know you can get it back if you want it. You don't want less than you deposited, and you don't want external market conditions constraining your need to have the money now.

Some tax advantages. Annual taxes on earnings or growth may be considered "carry costs" for unrestricted access. But if taxes can be eliminated or minimized, all the better.

Competitive returns. Mattress money actually meets all the previous provisions. But zero earnings from principal is unacceptable. Interest rates may be low, but even fractions of advantage make a difference.

A financial professional should be able to provide a menu of financial instruments that meet these criteria in varying degrees. Most likely, your career-change cash reserves will not be concentrated in one account. And over time the composition can change. For example, life insurance cash values can be an excellent storehouse for liquid reserves, but up-front policy expenses mean these values accumulate slowly in the contract's early years. A lot of your cash reserves might eventually be held as cash values, but probably not start there."

Mandatory career change: opportunity or disaster?

In the event of a period of extended unemployment, how would you respond? Remember, the goal is not to merely survive, but find other ways to progress toward your long-term financial objectives. Would you go back to school? Start a business? Buy rental property? These questions merit your attention. And depending on your answers, the conventional metric of cash reserves equal to 3-6 months of living expenses may not be nearly enough.

It's simple, really. True cash reserves are essential for addressing the risks of mandatory career change. Ignoring this risk, or improperly addressing it, increases the likelihood of never recovering from the financial fallout. ❖

- **WHAT ARE YOUR CASH RESERVES?**
- **ARE THEY SUFFICIENT TO MEET THE CHALLENGES AND OPPORTUNITIES OF A MANDATORY CAREER CHANGE?**

The Rule of 22 (or 21.47)

Calculating the True Cost of a Risk-Free, Guaranteed Retirement Plan

"Don't have a pension? Don't worry. Most people don't. They will get to retire, and so will you."

This is the optimistic opening statement from a 20-page white paper titled "A Pension Promise to Oneself" by Stephen Sexauer and Laurence Seigel, published in the November-December 2013 issue of the *Financial Analysts Journal*. The stated goal of the paper: To give Americans a simple model for retirement planning that "compresses 40-80 years of dynamic complexity into something that they can manage and understand" with a simple formula that "reduces the retirement calculation to a multiplication problem that a fifth grader can solve."

From a fifth grader's perspective, here's the bottom line: Your number is 22 (actually 21.47), and you need to save a lot of money.

The number 21.47 is a Retirement Multiple (RM). The RM determines the retirement account accumulation required for a "risk-free" retirement income. For instance, if you want to receive an income of $100,000 annually at age 65, your retirement account should be almost $2.2 million ($100,000 x 21.47).

The RM metric makes it fairly simple to self-assess your retirement progress. Besides giving you an accumulation target, you can also calculate the value of your current retirement savings. For example, if you currently have $300,000 in retirement assets, dividing the amount by 21.47 results in an annual income of $13,972.

Simple? Yes. But is it accurate?

What are the underlying assumptions? And are they realistic?

The main premise of the white paper is: individuals should see themselves as sponsors of a traditional defined benefit (DB) pension plan, one that delivers a guaranteed income "from the moment you retire until the end of your life or your spouse's life, whichever comes later."

The authors make certainty a priority. "We start by assuming that the investor wants to ***guarantee*** the desired income level, not merely have a high probability of achieving it." This means "investing with as little risk as possible, both before and after retirement." Meeting this objective requires very conservative assumptions about projected rates of return and consequently higher levels of saving, but offers the near-certainty of hitting your target.

Besides emphasizing guarantees, the article offers several practical arguments from human behavior for low-risk simplicity in retirement planning. Most individuals aren't financially savvy – "they do not fully grasp the difference between a stock and a bond, much less the difference between an expected return and a return one can count on." Even experienced investment professionals "suffer from an illusion of precision regarding return expectations," and complex plans "will simply not be widely adopted or [will be] adopted incorrectly in a way that hurts investors." Further, our cognitive skills decline with age. Retirees "do not want to couple this almost assured fall in clear thinking with a retirement plan full of complexity and risk taking."

The Retirement Multiple is derived from the performance of a hypothetical portfolio consisting of Treasury Inflation-Protected Securities (TIPS). Per Investopedia, "TIPS are considered an extremely low-risk investment," backed by the U.S. government, with values that rise with inflation. A website, www.dcdbbenchmark.com, updates the current RM (21.47 was used in the white paper; it was 21.85 for December 2013).

The authors state in their introduction, "Well-run DB pension plans provided retirement income for generations. When plans failed, it is because they broke the rules." The Rule of 22 distills the funding requirements of a compliant pension plan. If someone adheres to these no-risk guidelines for retirement planning, success depends on only one factor: **you just have to save money.**

Select a savings target, then figure out how to hit it.

In their retirement planning process, Sexauer and Seigel estimate an income stream that will be needed, and a target retirement age. These numbers are educated guesses. (In examples accompanying the article, the authors use 70% of projected earnings at age 65 as their annual retirement target.) The RM is applied to the target income, resulting in a lump-sum, and a savings plan is constructed to reach the goal. In order to meet their projections, most households will have to increase their saving over time – both at greater amounts, and a higher percentage of income. One recommended strategy is automatically allocating half of any pay increase to savings. Because life changes, the plan must be updated. But each adjustment uses the same items: the target income, the current RM, and a revised saving plan.

In three hypothetical examples (a teacher, a sanitation worker, and a software developer), the white paper applied this process to show how different career arcs and earning levels could achieve a risk-free, guaranteed retirement. Some common factors: Every future retiree started by saving at least 10% of their annual income in their first year of employment. In their final working years, they all were saving at least 20%, and in one case, more than 30%. When Sexauer and Seigel say a risk-free retirement "involves a lot of saving," they aren't kidding.

But the authors insist these scenarios are achievable. They cite large-scale studies showing saving rates of over 30% for the 55-60 age group for the top three quartiles in the United States. "We have shown that individuals saving for retirement are not facing a hopeless task. Far from it."

Optimistic, Sobering, Doable.

"A Pension Promise to Oneself" makes several thought-provoking statements about retirement planning. Instead of massaging projected rates of return and historical probabilities, the focus is on guaranteed results. In their words, "Assets must be accumulated according to an economically sound plan, and wishful thinking about markets must not be allowed to substitute for rational savings rates." This is a reality check about the costs of providing a truly secure retirement.

The simplicity of the calculations and the insistence on low-risk investing addresses key behavioral aspects in personal finance. In a vacuum, sophisticated retirement models may deliver superior results. In the real world, many savers would likely do just as well with a fifth-grade calculation and saving a large percentage of one's income. This planning process takes less time, and the results are less likely to disappoint.

Indirectly, Sexauer and Seigel imply that current retirement theories have somehow made a distinction between building an individual and corporate retirement plan. They insist the processes – and the funds required – are equivalent. In their words, "individuals can provide pensions for themselves almost as easily as employers can. It requires saving a lot of money – almost exactly the same amount…" And since this is true, they ask

"Why aren't these words spoken to every employee who begins to work at a company, government agency, or nonprofit organization? Why aren't they taught in schools? Why aren't they part of the advice lovingly given by parents to their children as adulthood looms?"

Find your number, and make a promise to yourself to save a lot of money. It is simple, challenging, and possible. ❖

Health Savings Accounts

Is the HSA a "Healthier" Individual Retirement Account?

Intervention in a complex system always creates unanticipated – and often undesirable – outcomes. Economists and sociologists call this the Law of Unintended Consequences. And while the unintended consequences that get our attention tend to be negative, there may be "happy accidents" as well. As the details from each phase of the Patient Protection and Affordable Care Act (PPACA) become apparent, some financial commentators think they may have uncovered some unexpectedly favorable possibilities.

Introduced in 2003, Health Savings Accounts currently permit individuals with high-deductible health insurance plans to contribute up to $3,300 annually on a pre-tax basis for anticipated out-of-pocket medical expenses (the threshold is $6,550 for a family, with an additional $1,000 if over age 55). Any earnings on the deposits are tax-free, as are withdrawals – as long as the money is used for qualified medical expenses. In addition, unused balances are allowed to accumulate. After age 65, HSA funds can also be used to pay insurance premiums, including Medicare and long-term care insurance.

Similar to an IRA or other qualified retirement plan, withdrawals for other purposes are taxable as regular income. However, if funds are withdrawn before age 65 for non-medical reasons, a 20% penalty is applied.

From this brief explanation, it's possible to see some attractive opportunities with HSAs. As Retirement Management Analyst Dana Anspach says:

"Where else do you get to contribute tax-deductible dollars and withdraw them tax-free? Health insurance premiums and medical expenses of some kind are a certainty. Why not pay for them with tax-free dollars? I can think of almost no downside to funding an HSA instead of an IRA. If you don't need your HSA funds for medical expenses or insurance premiums then after age 65, you can use the money just like funds in your IRA or 401k."

It is important to remember that you can't establish an HSA unless you also are enrolled in a qualifying high-deductible health insurance plan.

Some companies provide high-deductible health plans for their employees, often including some allocation to partially fund the accompanying HSA. But when the mandate that Americans must be enrolled in a health insurance plan became effective for individuals in January 2014, it indirectly expanded the number who might want to establish an HSA.

PPACA established minimum benefit provisions for individual health insurance plans. In many cases the new standards were more expansive than previous plans, and insurers were required to accept all applicants. Not surprisingly, offering more benefits on a guaranteed-issue basis has resulted in higher premiums, in some cases significantly higher. As an unintended consequence, these higher prices have compelled more individuals to consider high-deductible health plans – which may also make them eligible for HSAs. (Many of the policies in the PPACA's "bronze" classification qualify for pairing with an HSA.)

The investment options in an HSA vary by the provider. Some offer only guaranteed or low-risk choices, assuming most of the money will be distributed within a year of deposit. Other institutions include long-term choices, similar to those for IRAs and other qualified plans.

IRA or HSA?

For self-employed households and individuals in good health, HSAs may present an intriguing workaround to the higher costs of health insurance while still maintaining an accumulation program. If last year's budget included health insurance premiums and contributions to an IRA, it may be possible, for about the same amount of money, to construct a new plan using a high-deductible health plan and an HSA.

This arrangement is not equivalent to the old one; if the health plan premiums are about the same, the benefits from the new insurance coverage are probably less, and out-of-pocket medical expenses potentially higher. But using the HSA allows these additional out-of-pocket expenses to be paid on a tax-free basis, with unused portions accumulating for retirement. If the individual remains healthy, a larger portion of the HSA balance may eventually be allocated to long-term investments, like the IRA.

Even if an individual's budget could afford higher health plan premiums and still maintain IRA contributions, HSAs might be the more attractive option. Consider the chart below, showing the tax treatment of the three tax-favored accounts available to individuals.

Like Ms. Anspach says, out-of-pocket medical expenses are an almost certainty. This means some money accumulated in an HSA can almost certainly also be spent on a tax-free basis – well before retirement. A significant medical event presents one of the greatest risks for financial disruption, and accumulating a substantial reserve in an HSA is a financially efficient way to protect against it, both now and later. Improving longevity makes medical expenses a greater financial concern in old age, so the ability to take tax-free distributions in retirement for medical expenses, insurance and long-term care could be extremely valuable.

The constantly changing landscape of government regulation and tax policy makes it impractical to think that an HSA could be one's primary destination for retirement saving. But if your individual or employee circumstances include enrollment in a high-deductible health plan, the option to pair it with an HSA should be carefully evaluated, as there are many scenarios under which HSA funds may be deposited, grow, and be withdrawn completely free of tax consequences. ❖

Tax benefits of HSAs vs. retirement accounts

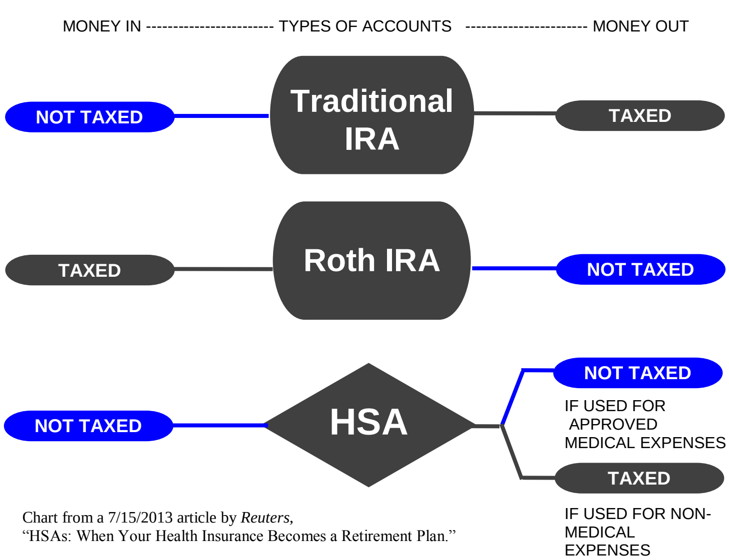

Chart from a 7/15/2013 article by *Reuters*, "HSAs: When Your Health Insurance Becomes a Retirement Plan."

It's easy to see how this happened, and also how easily it could have been prevented…

In 1996, Warren named his wife Judy the beneficiary on his group life insurance policy with Federal Employees' Group Life Insurance (FEGLI). Two years later, Warren and Judy divorced.

In 2002, Warren married Jacqueline. In 2008, Warren died unexpectedly. You can guess what happened. Ten years after his divorce and six years after his remarriage, Warren hadn't amended his FEGLI beneficiary. When Warren died, Judy was still his named beneficiary.

However, a Virginia statute says that when a couple divorces, they automatically terminate their spousal beneficiary status. This led to a dispute between the widow (Jacqueline) and ex-wife (Judy) over who was the rightful recipient of the FEGLI benefits. The case eventually made its way to the U.S. Supreme Court, which rendered a decision in June, 2013. The verdict: Judy, the ex-wife, was the legal beneficiary.

The Court ruled 9-0 for the listed beneficiary on a relatively technical matter: Because FEGLI insurance benefits were created by a federal law, the "Supremacy Clause" in the U.S Constitution states federal law has precedence over state law. The Court also pointed out that allowing states to arbitrarily override written beneficiary designations could make it too easy for litigants to question and undo the intentions of decedents (who can no longer speak for themselves).

Of course, the entire mess could have been settled if Warren had taken five minutes to complete an updated Change of Beneficiary form. If you care enough to insure your life, you want to make sure the benefits will be distributed according to your clearly-stated wishes.

Getting it right

There are two critical aspects to proper beneficiary designation: The name of the beneficiary, and the relationship of the beneficiary to the insured. The most common beneficiary is a natural person, but beneficiaries can also be trusts, charities, businesses, or other entities established by law. Regardless, proper identification is a must – names and titles spelled correctly, birthdates and trust dates listed accurately, etc. (Many financial institutions request a tax ID number as well.)

The definition of the beneficiary relationship matters as well. Does the beneficiary statement "all children of (the insured)" include those born after the policy was established, or, make a distinction regarding children from other relationships?

When to review

In general, any "life-changing event" should trigger a beneficiary review. These are events that reconfigure your finances or your relationships. An annual beneficiary check-up is a good idea, too. Life-changing events include:

- ☐ **Divorce.** This event can compel a range of beneficiary issues, some of which may be court-ordered. Besides life insurance, retirement accounts may be involved as well.
- ☐ **Death of a spouse.** Typically a big beneficiary issue, because spouses are often primary beneficiaries. If they die, who steps into the primary beneficiary position?
- ☐ **Additional children or grandchildren.** If benefits are intended for multiple beneficiaries, you may have to decide whether equal or proportionate distributions are "fair," especially when the proceeds are intended for grandchildren.
- ☐ **Change in employment status.** If you leave an employer, some of your benefits may be vested (many veterans have life insurance benefits). Retirement accumulations rolled into IRAs mean new beneficiary forms. Enrolling in a new menu of group benefits will also mean beneficiary paperwork.
- ☐ **Move.** Some financial instruments' only communication is an annual statement. If you have relocated, what are the chances the financial institution didn't get a forwarding address? The move may not immediately impact your beneficiaries, but if you don't receive statements, you might forget you have the asset. Losing track of an asset is almost as bad as having it go to the wrong beneficiary.
- ☐ **Dormant financial assets.** Paid-up life insurance policies and deferred annuities no longer receiving deposits can easily be overlooked. ❖

> If you care enough to insure your life, you want to make sure the benefits will be distributed according to your clearly-stated wishes.

> HAVE YOU HAD ANY LIFE-CHANGING EVENTS IN THE PAST YEAR?
>
> FIVE MINUTES OF REVIEW KEEPS YOUR BENEFICIARIES CURRENT.

First Financial Group

Jeffrey Bingham, CLU®, CFP®,CASL®
First Financial Group
1869 Charter Lane, Suite 201
Lancaster, PA 17601
(717) 393-4465 x 4126 (717) 393-6115 Fax
Email: jbingham@firstfinancialgroup.com